Opportunities and Pitfalls of Direct investment

Medium- to long-term investment opportunities with the potential for appreciation in value and/or constant, sustainable distributions are sought to balance out low-interest investments or – often erratic – stock market investments. To this end, the investment portfolio should be diversified to include real economic and tangible values. Private equity investments in general and, more specifically, investments in private companies, can meet these requirements. Equity investments in companies (so-called private equity) can be made directly or indirectly. Funds and investment companies aggregate numbers of investors and invest in multiple companies. If the individual investments are not known by the investors at the time of the investment commitment, this is called a blind pool investment. The investment choices and the investment decisions are made by an investment manager. The individual investor has little or nothing to do with the particular target companies. This form of investment is referred to as indirect investment. Alternatively, one or more investors can invest in a company directly. In this case, the investor is directly involved in the selection of the company and the investment decision. The investor can be supported by specialists in the transaction as well as the management of the investment. This form of investment is referred to as direct investment. The corporate direct investment segment has become more attractive, known and popular. There are ways to develop this type of investment opportunity in a targeted manner. However, some requirements for the investor and the company require special attention. One must possess the know-how and willingness to actively manage the investment.

Direct investment process:

- Researching and evaluating the target companies
- Analyzing the companies and their market potential
- Preliminary decision
- Engaging in due diligence and valuation
- Opportunity to invest as a sole, lead or co-investor
- Putting together consortia/club deals
- Investment decision
- Execution of the investment through negotiation, structuring, contracts, etc.
- Active value management with reporting, controlling, support, appropriate measures, etc.
- Active exit management

Who are the investors

Various types of investors are active in the private equity direct investment segment, including experienced entrepreneurs with free capital, wealthy private individuals or families, family offices, formally or informally organized investment clubs, business angels, investment platforms with qualified private investors, and crowd funding platforms, to name a few. Investments are financed by sole, lead, or co-investors.

The demands on the investor and his tasks in the investment process differ substantially from an indirect investment. The investor himself becomes a quasi-investment manager or can outsource this function to specialists. This approach makes high demands in terms of know-how and experience in evaluating companies, the investment process and investment management. In contrast to a professional investment manager, a direct investor's investment activities are generally not his main occupation. He may also operate his own company, manage a broadly diversified portfolio with additional types of investments, such as real estate and stocks, or engage in some other professional activity. Therefore, the investor must determine whether he has sufficient time to devote to this endeavor, since a financial commitment to a company requires a large commitment of time and thought on the part of the financial backer.

Important tasks for a direct investment – which must be performed by the investor himself or partially outsourced to specialists:

- Developing an investment strategy for the direct investment
- Structuring & administering the portfolio
- Ensuring compliance with regulations
- Sourcing and managing the deal-flow
- Evaluating investment proposals
- Valuation
- Due diligence, structuring & executing the investments
- Implementing corporate governance policies in investees
- Implementing professional reporting & controlling procedures
- Owner representation & Board of Directors mandates
- Strategic development of the company
- Ensuring that portfolio companies meet their targets
- Managing the cash flow generation and amortizing the bank financing
- Preparing for and implementing the exit

How does an investor benefit

The investor makes every investment decision himself: in which company to invest, at what valuation, with how much debt financing, the amount and the timing of dividend distributions, as well as the resale of the investment in the company. With direct investments in companies, investors can have a much stronger influence on the performance of their investments – in a positive or a negative way. The investor assumes direct entrepreneurial responsibility and this generally results in greater personal involvement. If he does so with professionalism, foresight and skill, the investor can profit directly from the financial success of the company. It is very important for a direct investor to know which tasks match his strengths and for what purposes he can and will expend his time. He must seek out competent and reliable partners to perform the tasks that he does not perform himself. Direct investment offers many advantages: transparency, decision-making authority vested in the investor, no overlapping fees, and the flexibility to individually structure and exert influence over the development of the company.

How does an entrepreneur or a company benefit

The need for equity capital arises for many reasons during the life cycle of a company. There are differences between start-up financing, growth financing, financing of acquisitions, turnaround financing and financing during a change of ownership (succession planning). Private equity investors offer the opportunity to obtain the necessary equity capital, whether (indirectly) through a PE fund or through a direct investor.

The classical private equity fund is a partner to the company for a limited period of time, which seeks a fair return on its investment and wishes to participate in the appreciation of the company. Therefore, it supports the company in reaching its goals and stands at its side with advice and its network. The selling price largely depends on the company's success. Therefore, the investor seeks to collaborate closely with management. Depending on the life cycle of the fund, the investment in the company must be resold within 3-7 years. This predetermined time horizon affects all business decisions during the holding period – and not always to the advantage of the company.

The direct investor generally pursues the same goals. The time horizon, investment strategy and type of influence exerted depend on the individual profile of the investor or group of investors. There is generally greater freedom to make decisions and act on them. The company profits from the business experience of the investors. Direct investors do not have to exit after a fixed holding period. Long-term or open-ended holding periods with dividend distributions can also be chosen as investment strategies. Often the corporate strategy is directed toward the long term.

The individuality of a direct investor is greater than that of an investment company. Moreover, the personal situation or interests of a direct investor can change over time. The interests and expectations of the stakeholders (investors, sellers, founders, management, or the families of key persons) must be coordinated before the investment decision is made. A discrepancy in expectations can result in serious problems. During the holding period of the investment, open communications and a high level of sensitivity are important parameters for success.

Active management as the key to success

Directly held investments in companies are, by definition, not passive investments. The investor must ensure that the investment is actively managed, whether he does so himself or acts through a qualified and committed lead investor or professional service partners. Some of the relevant tasks are: implementing adequate corporate governance structures in the company, institutionalizing owner representation on the Board of Directors, implementing professional reporting and controlling processes, active involvement in the strategic development of the company, taking measures to ensure that the portfolio companies reach their targets, as well as active management of the cash flow generation to amortize the bank financing.

Finding promising investment opportunities and implementing a sustainable growth strategy for the company while the investment is in the portfolio is demanding enough. But effectuating a successful sale of the company is often another major challenge. Early, professional exit planning and plan implementation are the prerequisites for this.

A successful direct investment is an extremely exciting and enriching experience. However, a direct investor should also be able to handle disappointment and decide on necessary changes. The prerequisites for a positive experience are realistic expectations and a professional approach.

Peter Letter
Managing Partner

paprico ag
partners for private capital & companies
Zugerstrasse 8a
6340 Baar

peter.letter@paprico.ch